

# **An Analysis of Liquidated Damage Clauses as a Method of Dispute Resolution Under Ohio Law**

## **I. INTRODUCTION**

Judge Learned Hand once remarked, "As a litigant, I should dread a lawsuit beyond almost anything short of sickness and death."<sup>1</sup> Business executives understand Judge Hand's reasoning. A lawsuit can cost a great deal of money to litigate. More than just money, however, can be lost by litigation. The time which a corporate officer must expend on details of the litigation is time which cannot be used to improve productivity or compete more effectively. Additionally, the attendant publicity associated with a lawsuit may adversely affect the corporate image. This situation may be especially true if the other party is able, through distortion in the media, to publicly portray the business as an aggressor—even if the court determines that the business was the victim. Consequently, businesses are frequently prepared to settle any potential litigation through formal or informal methods of dispute resolution. They are also prepared to preclude even the possibility of litigation. As a result, liquidated damage clauses are often included when commercial parties negotiate contracts.

Liquidated damage clauses are agreements by which contractual parties stipulate a specified level of damages to be awarded in the event that the contract is breached.<sup>2</sup> These clauses are promulgated by the parties when the contract is formed.<sup>3</sup> They appear to be an efficient means to preclude litigation or to resolve conflict if a dispute arises. Yet, several significant issues concerning the extent, or even wisdom of enforcing liquidated damage agreements exist under the present state of Ohio law.

When examining the use of liquidated damage agreements, a commonly held view is that two parties who have agreed to a contract should be held to its terms. Indeed, that is a general rule of law.<sup>4</sup> However, in Ohio, that rule is not applicable to liquidated damages. In order for liquidated damage agreements to be enforced, the clause must meet a very narrowly drawn set of guidelines.<sup>5</sup> Furthermore, there is reason to question whether liquidated damages should be enforceable in certain circumstances. For example, there is an implicit assumption that the con-

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1. J. HENRY & J. LIEBERMAN, *THE MANAGER'S GUIDE TO RESOLVING LEGAL DISPUTES* (1985).

2. 30 O. JUR. 3D Damages § 127 (1981).

3. *Id.*

4. *Id.*

5. OHIO REV. CODE ANN. § 1302.92(A) (Anderson 1979).

tracting parties have an equivalent level of bargaining power. That, unfortunately, is not always the case. A significant policy issue exists as to the wisdom of enforcing contractual settlements in the event that one party held significant leverage over another party during contract negotiation. In such situations, the weaker party would not only be denied its right to damages, but also its right to litigate. Effective dispute resolution methods should provide justice without litigation, not give the powerful a greater advantage.

The other side of this argument, however, is the need for certainty. Liquidated damage agreements are useful to commercial parties because, from the beginning of a contractual relationship, they preclude the possibility of litigation. Consequently, unlike the circumstances surrounding settlement negotiations, the passions of the parties are not inflamed. Rather, the parties have rationally determined what the level of damages should be in the event of a breach. If the courts refuse to consistently enforce these agreements, the advantages of liquidated damages are lost. When a party feels wronged, he may desire to litigate if he feels that any chance of winning exists. This desire to litigate may be present even if compensation has been previously agreed to in a liquidated damage clause. Should the judiciary, through its decisions, send mixed signals concerning the enforceability of such clauses, it is highly probable that many parties will test the validity of the liquidated damage clauses in court. Thus, liquidated damage clauses will have lost most of their value because the dispute was eventually litigated.

The purpose of this Note is to analyze the effectiveness of liquidated damage clauses as tools of dispute resolution under Ohio law. It will begin with a discussion of Ohio law as it exists today. The Note will present some common situations in which liquidated damage clauses are used and then examine some of the issues concerning these uses. Next, it will compare the liquidated damages to two of the more common methods of resolving business disputes—settlement agreements and binding arbitration. Finally, the conclusion will provide guidelines for the use of liquidated damage clauses in the current commercial environment and give suggestions for the improvement of current Ohio law.

## II. LIQUIDATED DAMAGES—CURRENT LAW IN OHIO

Liquidated damage law in Ohio is governed by a statute which is based on the Uniform Commercial Code. The statute establishes several conditions which must exist before any liquidated damage clause will be enforced by a court. First, the actual amount of damages must be uncer-

tain and difficult to prove.<sup>6</sup> Second, the amount of damages stipulated by the clause must not be unreasonable or unconscionable.<sup>7</sup> Finally, the contracting parties must have intended that the liquidated damages be awarded in the event of a breach.<sup>8</sup> If the damages awarded by the clause do not meet these conditions, then an Ohio court will consider such an award to be a penalty and will refuse to enforce it.<sup>9</sup> A recent case decided by the Ohio Supreme Court serves to illustrate how the current law is applied.

In the case of *Samson Sales v. Honeywell*, the plaintiff, Samson Sales, owned a pawn shop. The plaintiff entered into a contract with Morse Signal Devices by which Morse agreed to install and maintain a burglar alarm system. Morse was eventually taken over by the defendant, Honeywell, Inc., which assumed responsibility for the contract. Subsequent to Honeywell's takeover, Samson Sales was robbed. Honeywell, however, negligently failed to notify police of the break-in, as was required by the terms of the contract.<sup>10</sup> As a result of the robbery, Samson Sales lost a total of \$68,303 in merchandise. Samson Sales sued, but Honeywell defended itself by reason of a liquidated damage clause in the contract. That clause, written in fine print, limited Honeywell's liability to a sum of only fifty dollars.<sup>11</sup>

The Supreme Court determined that none of the requisite conditions for enforcing liquidated damage clauses were present in this case.<sup>12</sup> The court noted that damages could be precisely determined.<sup>13</sup> Moreover, the court stated that \$50, in view of the considerable loss, was an unconscionable sum which would act as a penalty if enforced.<sup>14</sup> Finally, the court stated that the liquidated damage clause did not reflect the intention of the parties. In reaching this final element of the decision, the court placed special emphasis on the fact that the liquidated damage clause was typed in small print. Furthermore, the court noted that the clause seemed to conflict with another contractual obligation of Honeywell which required it to notify the police in the event of a robbery.<sup>15</sup> As a result, the court voided the liquidated damage clause.<sup>16</sup>

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6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.* See *Samson Sales v. Honeywell*, 12 Ohio St. 3d 27, 465 N.E.2d 392 (1984). See also 30 O. JUR. 3d, *supra* note 2, at § 127.

10. *Samson Sales v. Honeywell*, 12 Ohio St. 3d 27, 27, 465 N.E.2d 392, 393 (1984).

11. *Id.*, 465 N.E.2d at 393.

12. *Id.* at 29, 465 N.E.2d at 394.

13. *Id.*, 465 N.E.2d at 394.

14. *Id.*, 465 N.E.2d at 394.

15. *Id.*, 465 N.E.2d at 394.

16. *Id.*, 465 N.E.2d at 394.

In comparison, Ohio's courts do not hesitate to enforce valid liquidated damage agreements. They have, for example, refused to set aside valid agreements in spite of the fact that greater damages than those stipulated have been incurred.<sup>17</sup> In order to obtain greater damages than those granted by a valid liquidated damage clause, the clause itself must contain a provision which allows for litigation in order to receive greater damages.<sup>18</sup> Although liquidation damage agreements appear to be an expedient method of dispute resolution, a number of problems mitigate against their use.

### III. PRACTICAL PROBLEMS WITH LIQUIDATED DAMAGE LAW

Liquidated damage clauses are used in a variety of commercial settings, from million dollar transactions to parking lot claim checks. Despite their seeming simplicity and efficiency, a number of problems currently inhibit their effectiveness. While liquidated damage law may appear straightforward, the contracting parties are usually not familiar with all of its ramifications. Consequently, when a court is called upon to settle a dispute concerning a liquidated damage clause, an injustice may result. This unfair consequence, in turn, raises policy issues concerning the circumstances in which liquidated damage agreements should be enforced. In order to fully understand the impact of liquidated damage clauses these problems and policy issues must now be examined.

The following is a hypothetical situation that examines the potential issues that arise. Assume that Royal Apartments negotiates a lease with Mr. Pleasant. Royal Apartments rents mostly to retirees who do not like loud noise. It is highly probable that if some tenants create loud noise, many of the retiree tenants will move out of the Royal Apartments. Royal Apartments, consequently, would be damaged economically. Because motorcycles make a great deal of noise, Royal Apartments forbids motorcycles on its premises. In its contract with Mr. Pleasant, a young person, Royal Apartments includes a liquidated damage clause by which Mr. Pleasant agrees to pay Royal Apartments fifty dollars each day he brings a motorcycle on its premises.

In the abstract, this pre-dispute settlement agreement seems reasonable. It also seems to fit the criteria for liquidated damage agreements. First, the level of damages seems difficult to ascertain. For example, while some tenants may specifically tell the management that they are moving because of motorcycle noise, others may not renew their lease for

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17. 30 O. JUR. 3D, *supra* note 2, at § 146.

18. *Id.* at § 145.

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a number of factors, of which motorcycle noise is one. Second, although the liquidated damage level is high, it is not unreasonable in view of the cost of rent and the potential loss for Royal Apartments. Finally, there should be no dispute that this clause was not the intent of the contracting parties. Both parties apparently had relatively equal bargaining power since Mr. Pleasant could rent elsewhere. Additionally, this clause does not conflict with any duties normally associated with either lessee or lessor. In applying the law to a similar situation, however, the Ohio Court of Appeals for Cuyahoga County reached a different result.

In *Berlinger v. Suburban Apartments*,<sup>19</sup> the court decided in favor of the tenant. The court conceded that actual damages resulting from a breach of the "no-motorcycle" ban would be difficult to prove, but stated that the amount was unreasonable.<sup>20</sup> (The court never addressed the intent provision, the third part of the liquidated damage test.) The court based its decision to not enforce the liquidated damage clause on the fact that the tenant was never seen or heard operating the motorcycle on the Apartments' premises. Rather, the motorcycle was only seen parked. The court conceded that damages might result from the operation of a motorcycle, but because no evidence had been introduced to demonstrate that the mere presence of a motorcycle had caused damages, the court ruled the liquidated damage clause invalid.<sup>21</sup>

The court's reasoning, in this case, is circular and prevents a legitimate tool of dispute resolution from being used. First, the distinction between "presence" and "operation" of a motorcycle is extremely thin. Few people "walk" their motorcycles for any distance in order to park them. Additionally, the court's requirement for evidence of damages begs the question. A valid liquidated damage clause requires that damages be difficult to ascertain. If the apartment complex could have demonstrated "[t]he amount of damages which might foreseeably result from the mere presence of a motorcycle,"<sup>22</sup> it would not have had to rely on a liquidated damage clause to be compensated. Indeed, such a clause would have been void under Ohio law.<sup>23</sup>

The court's decision is regrettable for yet another reason. It decreases the amount of certainty that the agreed-upon liquidated damage clause will be enforced in court. As previously explained, the elements of this case appeared to reasonably follow the guidelines established by Ohio

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19. *Berlinger v. Suburban Apartment Management Co.*, 7 Ohio App. 3d 122, 454 N.E.2d 1367 (1982).

20. *Id.* at 124, 454 N.E.2d at 1371.

21. *Id.* at 124-25, 454 N.E.2d at 1371.

22. *Id.* at 124, 454 N.E.2d 1371.

23. OHIO REV. CODE ANN. § 1302.92.

law. The court, however, voided the liquidated damage clause. In contrast, if the same damages had been agreed to in a valid settlement agreement<sup>24</sup> or validly awarded by an arbitrator (if the parties had agreed to arbitration),<sup>25</sup> the court would have enforced the agreement. Certainly, if the Apartment Company had proven damages during litigation, it would have been awarded those damages.

The *Berlinger* case has introduced confusion into the law as to what constitutes "reasonableness" in liquidated damage agreements. As a result, attorneys representing clients adversely affected by such agreements, are able to tell their clients that a reasonable chance for avoiding the agreement may exist. Consequently, litigation to test the validity of such agreements is more likely to ensue. Therefore, one of the principal reasons for using liquidated damage clauses, the avoidance of litigation, is lost. Since the use of liquidated damage clauses no longer offers significant protection from litigation, businesspeople may be less inclined to use them. As a result, other forms of resolving conflict, including litigation, are encouraged.

The non-enforcement of some liquidated damage clauses can create a number of problems. However, in other circumstances, their enforcement can also serve to inhibit the use of liquidated damage clauses as a tool of dispute resolution. The hypothetical can illustrate this point. Assume now that Royal Apartments has a contract with King Laundry Company to operate Royal Apartment's laundry room. The contract contains a liquidated damage clause by which, if Royal Apartments breaches the contract, it agrees to pay King Laundry damages equal to the amount of money which King Laundry earned from Royal Apartments in the previous month times the number of months remaining on the contract. The contract has eighteen months to run until it expires.

This liquidated damage clause again appears to be reasonable. The actual damages are uncertain, the liquidated damages reasonable, and the clause accurately reflects the "intent" of the parties. Furthermore, the parties seem to have equal bargaining power. In this situation though, a new twist occurs. Joker Laundry Company tortiously interferes with King Laundry's business by inducing Royal Apartment to breach its contract with King Laundry.

While some may argue that no significant problem exists because, if the liquidated damage clause is valid, King Laundry will be adequately compensated, it should be underscored that Joker Laundry committed a tort. Tortfeasors are liable not only for compensatory, but also for puni-

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24. See, e.g., 15 O. JUR. 3D *Compromise, Accord and Release* § 13 (1979).

25. See, e.g., OHIO REV. CODE ANN. §§ 2711.10 - 2711.11.

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tive damages. In the present set of circumstances, however, Ohio law would apparently allow Joker Laundry to escape unpunished.

The case of *Davison Fuel & Dock Co. v. Pickands Mather & Co.*<sup>26</sup> involved a similar situation. In that case, a dispute arose among a coal supplier, a coal delivery company and the ultimate purchaser of the coal. The dispute included many of the same issues contained in the Royal Apartments' example, but did *not* include a claim based upon a liquidated damage clause. Nevertheless, this case is important to the present discussion because of the decision made by the Court of Appeals for Hamilton County. The Court of Appeals stated that a party may maintain a cause of action against the party who breached the contract, the party who tortiously induced the breach, or both.<sup>27</sup> However, if the complaining party has fully recovered damages from the breaching party, then it cannot recover additional damages from the tortfeasor.<sup>28</sup> Furthermore, under Ohio law, no punitive damages can be recovered from a tortfeasor if no compensatory damages have been recovered from the alleged tortfeasor.<sup>29</sup>

Applying this reasoning to the hypothetical situation, it would appear that Joker Laundry would not be liable for any damages. The liquidated damage clause between Royal Apartments and King Laundry was valid. Additionally, if a liquidated damage clause is valid, Ohio's courts will only enforce the damages stipulated in the liquidated damage clause. Thus, King Laundry will have been fully compensated by its liquidated damage clause with Royal Apartments. Because it was fully compensated by Royal, King can seek neither compensatory damages nor punitive damages from Joker.

Admittedly, the situation in *Davison* did not involve a liquidated damage clause.<sup>30</sup> Moreover, in view of the propensity of courts to declare liquidated damages to be penalties,<sup>31</sup> it is not inconceivable that a court would conclude that this situation worked a "constructive" penalty against King Laundry. However, a high degree of doubt is created by the existing legal situation and, in fact, a California court decided a factually similar case in a similar manner.<sup>32</sup> As a result, comparing liquidated

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26. *Davison Fuel & Dock Co. v. Pickands Mather & Co.*, 54 Ohio App. 2d 177, 376 N.E.2d 965 (1977).

27. *Id.* at 181-82, 376 N.E.2d at 968.

28. *Id.* at 182, 376 N.E.2d at 968.

29. *Id.* at 180-81, 376 N.E.2d at 967.

30. *Id.* at 177-85, 376 N.E.2d at 966-67.

31. 30 O. JUR. 3d, *supra* note 2, at § 128.

32. *Fireman's Fund Ins. Co. v. Morse Signal Devices*, 151 Cal. App. 3d 681, 198 Cal. Rptr. 756 (1984).

In that case, Fireman's Fund was the insurance company for several businesses who had contracted for alarm services from Morse Signal. Each of the insured businesses had suf-

damages to other methods of resolving disputes once again places them in a less advantageous position.

If King Laundry had negotiated a settlement for the contract breach and business tort, it would have had very substantial leverage against Joker Laundry, and conceivably could have easily extracted some damages from Joker. The use of arbitration would also have likely resulted in Joker paying damages to King Laundry. If it had not required Joker to pay damages to King Laundry, the arbitration settlement may have been vacated by a court. If King Laundry had litigated the matter, he would have had a very good chance of obtaining damages. In any event, either negotiated settlement or arbitration would have provided a more acceptable and just solution than the enforcement of the liquidated damage clause.

Although some circumstances discourage the use of liquidated damage agreements, other situations may provide an incentive for their use, even if a manifest injustice occurs. In order to illustrate this point, return to the Royal Apartment's hypothetical situation. As a result of the previous problems with liquidated damage clauses, the owner of Royal Apartments has fired his old manager and is now in need of a new manager. Ms. Princess, a recent MBA graduate, applies for the job and is given an offer. In the employment contract, a covenant not to compete within the metropolitan area for a period of three years after termination of the employment contract is included. The contract also contains a liquidated damage clause which states that if the covenant not to compete is violated, Princess will be liable to Royal Apartments for \$5,000 in damages. Princess' annual salary will be \$32,000 and termination can be for any reason. Although Princess has an MBA, her choices are not unlimited.

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fered from theft or fire and, in each instance, the alarm system failed to properly notify the responsible authorities. Fireman's Fund, as the insurer, sued Morse Signal for a variety of claims. It also sought to invalidate the liquidated damage clauses in the contracts between Morse Signal and the insured businesses.

The court, however, upheld the liquidated damage clauses. The court stated that, although the liquidated damage clauses would be invalidated in the event of gross negligence, Fireman's Fund's complaint only alleged simple negligence. The court also stated that no claim was made that Morse Signal owed any duty to the insured businesses outside of the contractual relationship and that "[N]o breach of duty was alleged other than a failure to render the contracted for services." *Fireman's Fund Ins. Co. v. Morse Signal Devices*, 151 Cal. App. 3d 681, 691, 198 Cal. Rptr. 756, 762.

Undoubtedly, the tort situation in the hypothetical example is more direct and could possibly meet the California guidelines for invalidating liquidated damage clauses. Nevertheless, its uncertain outcome, as well as the dubious result in *Fireman's Fund*, indicates that this is an area which is in need of attention if liquidated damage clauses are to become more useful as a dispute resolution tool.

*See also* 22 AM. JUR. 2D *Damages* § 689 (1988).



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Furthermore, most employers in Ohio have some form of a covenant not to compete. Consequently, Princess decides to accept the offer.

A year passes and now Junior, the son of Royal's owner, graduates from the local business college with an MBA. In order to keep the business completely in family hands, the owner terminates Ms. Princess' employment. A competing apartment complex, however, has witnessed Princess' extraordinary management ability and subsequently hires her. Unfortunately, Princess will be required to pay Royal Apartments the liquidated damages stipulated in the original employment contract.

Under Ohio law, covenants not to compete are valid provided they are not unconscionable.<sup>33</sup> Ohio's courts have even enforced these covenants when, as in Princess' case, the employee has been terminated.<sup>34</sup> Additionally, Ohio's judiciary has upheld the use of liquidated damage clauses in enforcing non-competition covenants<sup>35</sup> because, "[a]mong the many contracts where the amount of damages suffered by the breach thereof will be almost impossible to prove are contracts where one of the parties agrees not to engage in a particular kind of business or profession. . . ."<sup>36</sup> Consequently, it must be concluded that Ohio's courts will enforce liquidated damage clauses that affect covenants not to compete even when the employee has been terminated. That outcome, however, is not fair and is not in the interests of encouraging dispute resolution.

One of the goals of dispute resolution should be to provide a fair and equitable settlement or hearing for any grievance. When liquidated damage clauses are applied to non-competition agreements, however, an equitable settlement is often precluded because the respective contracting parties were in unequal bargaining positions when the employment contract was negotiated. In the hypothetical situation between Royal Apartments and Ms. Princess, Ms. Princess was in a clearly inferior bargaining position. She had no real power to negotiate any of the terms

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33. OHIO REV. CODE ANN. § 2711.10.

34. *See, e.g.*, *Raimonds v. Van Vlerah*, 42 Ohio St. 2d 21, 325 N.E.2d 544 (1975).

35. *Id.*, 325 N.E.2d 544.

36. *See, e.g.*, *Lange v. Werk*, 2 Ohio St. 519 (1853). *See also* 30 O. JUR. 3D, *supra* note 2, at § 144.

It is interesting to note that various states treat liquidated damage agreements in non-competition agreements differently. Most states, including Ohio, uphold such agreements if they are reasonable. Pennsylvania and Michigan courts, however, have invalidated such provisions as being penalties. Massachusetts has taken the view that such agreements are neither liquidated damages nor penalties, but a contractual price for engaging in a competitive business. The Supreme Court of Louisiana, on the other hand, has refused to enforce such liquidated damage agreements because of a state law prohibiting noncompetition agreements. For further reading about this issue, see 22 AM. JUR. 2D, *supra* note 32, at § 720.

affecting her employment contract. The non-competition agreement and associated liquidated damage clause were virtually forced upon her.

Normally, when examining liquidated damage clauses, Ohio's courts are very sensitive to this unequal relationship because it is an indication of the intention of the contracting parties to accept any liquidated damage clause.<sup>37</sup> This standard, however, has not proven very persuasive in judicial decisions affecting non-competition agreements.<sup>38</sup>

This is not to suggest that Ohio's courts would uphold any liquidated damage clause which was supported by an unconscionable agreement not to compete.<sup>39</sup> Nor does it suggest that Ohio's courts would enforce a clearly unreasonable liquidated damage claim. However, it appears that Ohio courts have not been as sensitive as they should be to issues involving unequal bargaining positions and liquidated damage clauses. Furthermore, a fundamental question of fairness must be raised when courts enforce liquidated damage clauses as a means of settling disputes between employers and employees.

In addition to being unfair, the use of liquidated damage clauses to enforce covenants not to compete or to settle disputes between employers and employees harms the cause of dispute resolution. Courts are viewed as guarantors of justice. Consequently, when people feel wronged, they turn to the justice system to seek redress. When courts enforce out-of-court settlements which are viewed as "unfair", people naturally tend to reject the idea and use of out-of-court settlements. As a result, the amount of litigation increases and methods of dispute resolution are eschewed.<sup>40</sup>

It is undisputed that, in the Ms. Princess situation, every alternative means of resolving the dispute would have awarded some measure of damages to Royal Apartments. Covenants not to compete are legal in Ohio. Therefore, a settlement agreement (if one could have been reached), arbitration award, or resulting litigation would have favored Royal Apartments. The difference, however, is that with a liquidated damage clause, Princess did not have the opportunity to present her case. At the time of her employment Ms. Princess was forced to decide between a job or an automatic waiver of her right to dispute damages. That "forced" waiver and the lack of opportunity to present her side is

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37. *Hattersly v. Waterville*, 4 OCC NS 242, 249, 26 OCC 226 (1904).

38. 30 O. JUR. 3D, *supra* note 2, at § 132.

39. Noncompetition agreements are frequently negotiated in the context of an employer-employee relationship. As this article has previously stated, that relationship often involves an unequitable bargaining position which forces the employee to choose between unemployment or the agreement. Since Ohio's judiciary has not invalidated these agreements, the author feels that the statement concerning the courts' lack of sensitivity is justified.

40. *See, e.g.*, 30 O. JUR. 3D, *supra* note 2, at §§ 145-46.

why liquidated damage clauses, in the case of employer-employee disputes, should not be enforced.

#### IV. PUBLIC POLICY GOALS—DISPUTE RESOLUTION AND LIQUIDATED DAMAGES

There are a number of problems associated with the use of liquidated damage agreements. In order for them to become a more acceptable means of dispute resolution, some corrective action must be taken. Before such action can be initiated, however, it is necessary to understand society's general goals for dispute resolution. Once these public policy goals are known, a comparison to liquidated damage law can be made. Discrepancies can be identified and remedial action can be suggested.

These general policy goals for dispute resolution will be identified in the following section. It will then be demonstrated how certain aspects of Ohio law support these policy goals. A comparison will then be made to liquidated damage law. Although the list of goals is not intended to be exhaustive, it will provide a general framework for analysis.

While courts may have a variety of motives for supporting alternative methods of dispute resolution, a principal policy reason is the reduction of the courts' workload.<sup>41</sup> Throughout most of the nation, judges and attorneys are generally overworked and long delays exist from the filing of a complaint until its actual court date.<sup>42</sup> Ohio law indicates a support for this policy goal of reducing court congestion. For example, a settlement of disputes is so favored that, after a settlement has been agreed upon, a cause of action can only be maintained on the settlement and not the original cause of action.<sup>43</sup> Ohio has further supported this policy by codifying an arbitration statute which enforces arbitration awards.<sup>44</sup> Liquidated damage clauses also support this policy because they provide an

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41. See generally Hensler, *Court Annexed Arbitration*, ADR AND THE COURTS: A MANUAL FOR JUDGES AND LAWYERS 40-41 (1987). It is implicit that dispute resolution must be fair in order to be successful. If such a system is not fair, then at least one of the parties will have reason not to opt for this procedure. In recognition of this fact, most dispute resolution procedures have fairness as one of their goals. The dispute resolution process, if structured correctly, seems to be accomplishing this objective. For example, in a survey of participants to arbitration proceedings in Pittsburgh and Bucks County, Pennsylvania, and Burlington County, New Jersey, researchers found a great deal of satisfaction with the fairness of the process. This was true even of the litigants who lost their case.

42. *Id.* at 23.

43. 15 O. JUR. 3D, *supra* note 24, at § 13.

44. OHIO REV. CODE ANN. § 2711.01.

effective means of resolving disputes when properly drafted. The amount of damages is fair and courts will enforce the agreement.

There is a general consensus that, in the absence of some type of fraud, private settlements are a benign and effective method of reducing the courts' workload. Some legal scholars disagree with this general rule. Professor Morgan, of the University of Toronto, has produced a seminal article examining the question of when contractual conflicts should be allowed to be settled by dispute resolution and when these conflicts should be adjudicated by a court.<sup>45</sup> Professor Morgan argues that common law contractual disputes are essentially private and involve individual rights. He believes those conflicts are ideally suited for dispute resolution.<sup>46</sup> On the other hand, conflicts which involve statutorily created claims, such as allegations of antitrust violations, usually involve some type of societal, as well as private, interest.<sup>47</sup> Professor Morgan asserts that these societal disputes should be settled only in the society's forum, the court.<sup>48</sup> As a result, he is highly critical of the Supreme Court's decision in *Mitsubishi Motor Corp. v. Soler Chrysler Plymouth, Inc.*<sup>49</sup> which enforced a contractual agreement to arbitrate disputes even though the complaint contained allegations of antitrust activity.<sup>50</sup> Despite the objections of Professor Morgan and like-minded individuals, the practical result of the Supreme Court's ruling (as well as the staggering increase in litigation) is that public policy will continue to support private methods of dispute resolution for the foreseeable future.

A second policy objective for alternative methods of dispute resolution is that the settlements awarded by these methods be granted the effect of *res judicata*.<sup>51</sup> The reasoning behind this policy is simple. If the awards from such procedures were appealable, like normal court trials, then the benefits of dispute resolution would be nullified.<sup>52</sup> Ohio's legal procedures

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45. Morgan, *Contract Theory and the Sources of Rights: An Approach to the Arbitrability Question*, 60 S. CAL. L. REV. 1059 (1987).

46. *Id.* at 1069-75.

47. *Id.* at 1076-81.

48. *Id.*

49. *Mitsubishi Motors Corp. v. Soler Chrysler Plymouth, Inc.* 473 U.S. 614 (1985).

50. Morgan, *supra* note 45, at 1076-80.

51. See generally Comment, *The Res Judicata Standard of Confirmed Arbitration Awards in Wisconsin*, 1987 WIS. L. REV. 895. The Gilchrist article exposes a potential conflict in the standard of *res judicata* which is applied to confirmed arbitration awards. Apparently in Wisconsin there is confusion as to whether the civil-judicial or the arbitration standard should be used.

It is not the purpose of this article to explore the *res judicata* issue as thoroughly. Rather, it intends merely to raise the issue as an important component of dispute resolution.

52. See, e.g., *City of Madison v. Frank Lloyd Wright Foundation*, 20 Wis. 2d 361, 122 N.W.2d 409 (1963).

have been generally supportive of this policy objective. As has been previously explained, settlement agreements<sup>53</sup> and arbitration awards<sup>54</sup> are enforced by courts. Ohio's liquidated damage law is also supportive of this policy. If the clause fulfills the statutory requirements, then the court will only enforce the amount stipulated by the award.<sup>55</sup>

The third major policy goal for methods of dispute resolution is that the process be fair.<sup>56</sup> The judicial system applies the law and dispenses justice. Any acceptable alternatives to the judicial system must accomplish these goals.<sup>57</sup> In general, Ohio law concerning dispute settlements establishes procedures for rescinding an unjust settlement. For example, if a party can prove fraud or mutual mistake, then the courts will not enforce a settlement agreement.<sup>58</sup> Ohio's Arbitration Statute also mirrors this concern for fairness. Section 2711.10 of the Ohio Revised Code states the circumstances under which arbitration award may be vacated in Ohio.<sup>59</sup> Basically, an award may be vacated if corruption, fraud, misconduct, or partiality is demonstrated.<sup>60</sup> In that event, the court may, if time to reach agreement has not expired, resubmit the matter to arbitrators.<sup>61</sup>

While other methods of dispute resolution have been very supportive of the "fairness" policy, liquidated damage clauses have had a mixed record. On the one hand, courts will only enforce such clauses if the amount stipulated is reasonable<sup>62</sup> and the parties intended that such a sum be liquidated.<sup>63</sup> Otherwise, Ohio's courts will declare such "damages" as penalties and will not enforce them. On the other hand, Ohio's courts have not closely examined the "intent" of parties when enforcing non-competition agreements between employees and employers.<sup>64</sup> Consequently, liquidated damage clauses may appear to be unfair.

The final policy goal to be discussed is certainty of enforcement. This goal is important because it serves to preclude litigation. When the con-

53. 15 O. JUR. 3D, *supra* note 2, at § 145.

54. OHIO REV. CODE ANN. § 2711.01.

55. 30 O. JUR. 3D, *supra* note 2, at § 145.

56. Hensler, *supra* note 41, at 32.

57. See, e.g., Hensler, *supra* note 41, at 32, 40-42.

58. 15 O. JUR. 3D, *supra* note 24, at § 17.

59. OHIO REV. CODE ANN. § 2711.10. See also Section 2711.01 for conflicts that are precluded from arbitration.

60. OHIO REV. CODE ANN. § 2711.10.

61. OHIO REV. CODE ANN. § 1302.92.

62. *Id.*

63. *Id.*; see generally 30 O. JUR. 3D, *supra* note 2.

64. Because Ohio's courts have routinely enforced such agreements with much examination of the relative bargaining position of the employer and employee, the author feels this statement is well taken. See, e.g., *Raimonde v. Van Vlerah*, 42 Ohio St. 2d 21, 325 N.E. 2d 544 (1975).

flicting parties perceive that a challenge to an award, which has been granted by a method of dispute resolution, will be defeated in court, then they are much less likely to maintain litigation. In Ohio, settlement and arbitration law supports this policy because both of these methods provide only a very narrow set of grounds by which an award can be vacated.<sup>65</sup> Liquidated damage clauses, however, pose a completely different situation.

Liquidated damage clauses, by contrast, can be enforced under a very narrow set of circumstances.<sup>66</sup> Consequently, there are a large number of circumstances under which they can be voided. For example, the *Berlinger* case provided a situation in which the litigated damage clause seemed reasonable, yet the court still voided the clause.<sup>67</sup> In another case, the court of appeals for Franklin County invalidated a liquidated damage clause because the amount of damages which could have *potentially* been forfeited was unreasonable.<sup>68</sup> It is apparent that Ohio courts are able to exercise a high degree of discretion with liquidated damage clauses. As a result, the certainty of having these provisions enforced is relatively low.

#### V. STRATEGIC PLANNING—A COMPARISON AMONG ARBITRATION, SETTLEMENT AGREEMENTS, AND LIQUIDATED DAMAGES

The conflicting parties must examine each method before deciding upon which method of dispute resolution to use. There are unique advantages and risks associated with each method. This section will compare the respective assets and liabilities of arbitration, settlement agreements, and liquidated damages.

Although agreements to submit conflicts to dispute resolution are structured differently, they have a great deal in common. First, all of the methods are based upon contractual agreements. Liquidated damage agreements are clauses within a larger contractual setting.<sup>69</sup> Binding arbitration requires an agreement before any dispute can be arbitrated.<sup>70</sup> Settlement agreements, whether oral or written, are contracts.<sup>71</sup> Finally,

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65. See 15 O. JUR. 3D, *supra* note 24, § 17 at 532. See also OHIO REV. CODE ANN. § 2711.10.

66. Liquidated damage agreements will only be enforced if provisions of OHIO REV. CODE ANN. § 1302.92 are met.

67. *Berlinger v. Suburban Apt. Mgmt. Co.*, 7 Ohio App. 3d 122, 454 N.E.2d 1367 (1982).

68. *Welch v. K-Beck Furniture Mart*, 3 Ohio App. 3d 171, 444 N.E.2d 48 (1981).

69. See generally 30 O. JUR. 3D, *supra* note 2, at § 128.

70. See generally OHIO REV. CODE ANN. § 2711.01.

71. See generally 15 O. JUR. 3D, *supra* note 24, at § 3.

provided the agreements are valid, a court will enforce the amount of damages which have been awarded by the alternative means of dispute resolution.<sup>72</sup>

These methods, however, differ in a number of ways. The first aspect which differs is the timing of the agreement. Liquidated damages are agreed to when the contract is formed.<sup>73</sup> Settlement agreements, logically, cannot be negotiated until after a dispute has arisen.<sup>74</sup> Agreements for arbitration can be formulated either at the time the contract is created, or after a dispute has occurred.<sup>75</sup>

The timing of the agreement is very important to a party who is seeking to avoid litigation. Once a conflict has occurred and passions are inflamed, the opposing parties may actually desire litigation.<sup>76</sup> Consequently, a party that desires to avoid litigation from the outset of its contractual relationship, may wish to use a liquidated damage clause or to stipulate arbitration. Either of these methods would help to preclude some of the irrational thinking that frequently occurs with conflicting parties.<sup>77</sup>

Another difference between the various methods is the amount of control the parties have in determining the final award. Arbitration provides the parties virtually no control. The parties can control the decision not to litigate, but after the choice is made, they have little influence over subsequent events.<sup>78</sup> The arbitrator, or panel of arbitrators, fully examine the dispute.<sup>79</sup> The arbitrator then decides to make an award pursuant to statutory guidelines.<sup>80</sup>

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72. See 30 O. JUR. 3D, *supra* note 2, at § 145; OHIO REV. CODE ANN. § 2711.01; 15 O. JUR. 3D, *supra* note 24, at § 13.

73. 30 O. JUR. 3D, *supra* note 2, at § 127.

74. 15 O. JUR. 3D, *supra* note 24, at § 3.

75. OHIO REV. CODE ANN. § 2711.01.

76. J. HENRY & J. LIEBERMAN, *supra* note 1, at 8-9. See also F. KNEBEL & G. CLAY, *BEFORE YOU SUE* 13-15 (1987).

77. J. HENRY & J. LIEBERMAN, *supra* note 1, at 8-9.

78. Assuming that the businesspeople submit their dispute to the American Arbitration Association, the parties do have some say in choosing the arbitrator. Each side is presented with a list of people who are experienced in the business of the conflicting parties. The conflicting parties are able to strike unacceptable names and to list their desired choices of both, and no person whose name was stricken will be appointed. See R. COULSON, *HOW TO STAY OUT OF COURT* 143 (1984). See also OHIO REV. CODE ANN. § 2711.04 for statutory guidelines concerning the appointment of an arbitrator.

Some scholars argue that since legal procedural rules do not apply to arbitration, businesspeople feel in control of the situation. See R. COULSON, *supra* note 78, at 143. However, after the arbitrator is chosen, the respective parties do not really control the settlement process. Certainly, as compared to settlement negotiation or liquidated damage agreement negotiation, they exercise much less control over the ultimate award.

79. OHIO REV. CODE ANN. § 2711.06; R. COULSON, *supra* note 79, at 143-44.

80. OHIO REV. CODE ANN. § 2711.08.

Alternatively, settlement agreements and liquidated damage agreements provide a great deal of control. The parties are able to directly negotiate their position. The resulting agreement, or decision to litigate, is a product of each side's negotiating skill and strength.<sup>81</sup> The limitation of these methods, obviously, is that the opposition has a similar level of control. Thus, unless one side is on a clearly advantageous bargaining position or both parties are amenable to negotiation, a stalemate can occur. This presents a significantly different situation from the case of arbitration in which a settlement award is guaranteed.<sup>82</sup> In spite of their potential problems, parties favoring control of negotiations will probably be more inclined to choose liquidated damage or settlement agreements over arbitration.

The final area of contrast among the various methods is certainty of enforcement. Arbitration awards and settlement agreements are much more likely to be enforced by courts than liquidated damage clauses. The reason for this difference is the narrow set of circumstances under which liquidated damage clauses will be enforced compared to the other two methods.<sup>83</sup>

The differences that exist between the methods is critical because parties who enter into dispute resolution want to be certain that the other side will be required to perform under the agreement. If there is doubt as to whether the agreement will be enforced, the parties may decide to litigate. Consequently, those parties who wish to avoid litigation and have any agreement enforced, would choose arbitration or settlement agreements.

## VI. RECOMMENDATIONS

Liquidated damage agreements, as this Article has explained, are not very effective as a means for dispute resolution in Ohio. They present a number of practical problems and violate public policy concerning dispute resolution. Several recommendations for improving existing law will now be presented. While some suggestions may appear radical, they

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81. See generally 30 O. JUR. 3D, *supra* note 2, at § 127; 15 O. JUR. 3D, *supra* note 24, at § 3.

82. Obviously negotiations for a settlement or liquidated damage agreement could break down. In the former case, litigation would probably result; in the latter case, the negotiation process might start again in case of a dispute. In the case of arbitration, some type of final award will be made. See generally OHIO REV. CODE ANN. § 2711.08.

83. See, e.g., 15 O. JUR. 3D, *supra* note 24, at § 17; OHIO REV. CODE ANN. § 1302.92; 30 O. JUR. 3D, *supra* note 2, at § 128.



should be judged in light of the policy supports for dispute resolution which this paper has identified.

First, liquidated damage agreements between employers and employees should be invalidated. The employer is usually in a superior bargaining position compared to the employee. Consequently, it is relatively easy for an employer to force such an agreement on an employee. Although courts will not enforce unconscionable liquidated damage clauses, a statutory provision concerning employer/employee agreements would be beneficial for several reasons. Undoubtedly, many unconscionable liquidated agreements are not litigated because the employee is ignorant of the law and assumes he has no recourse. The proposed statute would provide greater protection and notice to the employee. Additionally, the statute would benefit the entire dispute resolution movement. Although most methods of dispute resolution provide awards similar to those of valid liquidated damage clauses, they do not contain the same psychological implication of unfairness. As a result, the statute would indicate to many individuals the inherent fairness of the dispute resolution process.

Some may argue that this recommendation does not go far enough. They may argue that the legislature should specifically invalidate every situation in which an inequitable bargaining position exists. Such an extreme course is not recommended. The current law covers such problem areas<sup>84</sup> and, in fact, Ohio's judiciary has done a credible job of screening liquidated damage agreements for evidence of inequitable bargaining positions.<sup>85</sup> Only in employer/employee situations has its vigilance been somewhat lax.<sup>86</sup> It is because of the distinct discrepancy in bargaining power between employers and employees, as well as the courts' lack of sensitivity to this situation, that it is specifically recommended that employer/employee liquidated damage agreements be prohibited.

A second recommendation is that the commission of a tort should invalidate any liquidated damage agreement. There are two specific reasons which support this recommendation. First, the result under current law may render an injustice.<sup>87</sup> In the previous hypothetical situation, Joker Laundry, the party who induced the breach between Royal Apartments and King Laundry, was not liable for any damage due to the validity of a liquidated damage agreement. Thus, King Laundry, the in-

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84. Ohio courts must examine the intent of the parties in agreeing to liquidated damage agreements in order to determine whether an injustice has occurred. *See* 30 O. JUR. 3D, *supra* note 2, at § 132-36.

85. *Id.*

86. *See, e.g.,* *Lange v. Werk*, 2 Ohio St. 519 (1853); *Raimonde v. Van Vlerah*, 42 Ohio St. 2d 21, 325 N.E.2d 544 (1975).

87. *See, e.g.,* *Fireman's Fund Ins. Co. v. Morse Signal Devices*, 151 Cal. App. 3d 681, 198 Cal. Rptr. 756 (1984).

jured party, could not seek any redress against Joker Laundry. King Laundry's lack of a course of action highlights the second reason why the commission of a tort should invalidate a liquidated damage agreement. The existence of a cause of action would serve as a deterrent to potential tortfeasors. Because there is currently no threat, tortfeasors are able to act with impunity.

A third recommendation is that parties be allowed to stipulate damages regardless of certainty of their amount. Businesspeople desire to use liquidated damage clauses for a number of reasons. They help preclude the possibility of litigation. Furthermore, liquidated damage clauses have the desirable aspects of timing (they are agreed to prior to any conflict) and control (the individual party has the opportunity to negotiate the award himself). Eliminating the requirement of "uncertain damages"<sup>88</sup> would allow liquidated damage agreements to be used in many more situations and would also increase the certainty of their enforcement by the courts because there would be fewer grounds for invalidating the agreements. This revision would also support our society's general policy to allow parties to contract their own settlement agreements.<sup>89</sup>

The acceptance of this proposal, while generally beneficial, would also carry some liabilities. Courts would need to maintain a high level of scrutiny of these agreements because abuse would be much more likely.<sup>90</sup> If any award can be negotiated, one party might force an inequitable award on the other party. As a result, courts would be required to examine "intent" very closely. Even under such a revised statute, however, courts could still invalidate the agreement on grounds of unconscionability.<sup>91</sup>

Finally, the legislature should enact a statute which requires the referral of all conflicts involving invalidated liquidated damage agreements to arbitration, not litigation.<sup>92</sup> This statute should be enacted because it is more consistent with the original aims of the contracting parties. At the time of the contract formation, a primary motivation for the adoption of

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88. OHIO REV. CODE ANN. § 1302.92.

89. See, e.g., 15 O. JUR. 3D, *supra* note 24, at § 12.

90. In the case of unequal bargaining positions, for example, it might be possible for the more powerful party to stipulate an exorbitant amount as liquidated damages.

91. OHIO REV. CODE ANN. § 1302.92(A), for example, invalidates any "unreasonably large liquidated damages." It is intended by the author that this type of provision remain in the recommended statute.

92. The author, of course, intends that this provision not apply to employment contracts. Because the first recommendation was that liquidated damage agreements between employers and employees be invalidated, the author assumes that the final recommendation will not be applicable to employment contracts. This is not to say that employers and employees should be prohibited from settling their conflicts short of litigation. Rather, the employee should not be required, as a condition of employment, to waive his/her rights.

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a liquidated damage clause is the desire of the parties to avoid litigation. Currently, if a liquidated damage agreement is invalidated, there is no automatic referral to another method of dispute resolution. The parties must either negotiate and reach a settlement or litigate. The proposed arbitration, therefore, would better serve the original intent of the parties.

This recommended legislation would also better serve public policy goals. The judicial system is inundated with civil litigation. This arbitration proposal would reduce the amount of litigation because it would provide a different conduit for resolving disputes. Furthermore, this proposal would not hinder policy concerns about the individual right to litigate since, as explained previously, this change is more consistent with the original intention of the parties. While the present law does not contain any such provision, contracting parties may be able to achieve the same effect if they included such a clause in their original contract. Ohio's judiciary has not previously examined this type of situation. A Texas court, however, decided a similar situation that serves to illustrate this point.

The case of *Ferguson v. Ferguson*<sup>93</sup> involved a dispute concerning a decedent's estate. The parties to this action agreed to submit all disputes involving the estate to arbitration. Furthermore, the parties included a liquidated damage clause into their agreement. The clause stated that any party that failed to abide by the arbiter's decision would forfeit twenty-five thousand dollars to the other party. When one party breached the agreement, the other party went to court in order to enforce the liquidated damage clause.<sup>94</sup>

The court of appeals began its analysis by determining that the amount of liquidated damages was not unconscionable. The court based this determination on the size of the estate and potential legal expenses that could be incurred in the litigation or settlement.<sup>95</sup> The court then stated that the respective parties were fully aware of their actions when they entered into their agreement.<sup>96</sup> The court also believed that the decision to arbitrate was not against public policy.<sup>97</sup>

The court then examined the issue of whether the parties could contractually waive their right of appeal. The court found such agreements valid under Texas law.<sup>98</sup> Therefore, the use of a liquidated damage

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93. *Ferguson v. Ferguson*, 110 S.W.2d 1016 (Tex. Civ. App. 1937).

94. *Id.* at 1017-18.

95. *Id.* at 1019.

96. *Id.* at 1020.

97. *Id.*

98. *Id.* at 1021.

clause to enforce an arbitration agreement was valid.<sup>99</sup> In reaching this decision, the court stated:

[i]t seems to us that if agreements to arbitrate are . . . favored by the Constitution and laws of our state, certainly a collateral agreement in the nature of a covenant (defining in advance the remedies of the parties in case one of them refuses to abide [by] the results of the arbitration thereby preventing the arbitration from having its contemplated effect) could not be said to contravene public policy.<sup>100</sup>

Applying the foregoing reasoning, it seems reasonable to conclude that any agreement to refer an invalidated liquidated damage clause to arbitration would be upheld. Additionally, the *Ferguson* case provides a sound policy argument for the codification of this practice.

## VII. CONCLUSION

While discussing the merits of civil litigation, Abraham Lincoln once said, "Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser—in fees, expenses and waste of time."<sup>101</sup> Those words are even more applicable today than when they were first spoken. The current litigation explosion wastes the courts' and litigants' valuable resources. Because of these problems, dispute resolution is increasingly being suggested as an alternative to litigation. This Article has examined the merits of liquidated damage agreements as a method of dispute resolution.

It was determined that liquidated damages are not very effective. They can be upheld in only a very narrow set of circumstances. Consequently, courts have a great deal of latitude in evaluating these agreements. They are frequently invalidated even when they appear reasonable. By contrast, the enforcement of certain liquidated damage agreements can work an injustice. This injustice may affect either the non-breaching party, such as a tort victim, or the breaching party, such as an employee.

As a result of the problems associated with liquidated damage agreements, an examination of society's basic goals for dispute resolution was then conducted and a comparison made to existing liquidated damage laws. Not surprisingly, several discrepancies were identified. Strategies for coping with these problems, including the use of other methods of dispute resolution, were then presented. Finally, a series of recommenda-

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99. *Id.*

100. *Id.* at 1022.

101. J. HENRY & J. LIEBERMAN, *supra* note 1.

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tions for improving the current state of liquidated damage law were made.

In this era of voluminous litigation, it is critical that parties be able to resolve disputes of their own accord. It is also important that those methods be effective and fair. Liquidated damages can play an important role in resolving disputes and preventing litigation. The framework provided can, hopefully, make liquidated damage agreements a better alternative than the "sickness and death"<sup>102</sup> mentioned by Judge Hand.

*John Sheppard*

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102. *Id.*

